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SUPREME COURT, U. S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

No. 72- 72-523

PLANTATION PATTERNS, INCORPORATED, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

JOHN S. JEMISON, JR., AND MARIE S. JEMISON, *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEALS FOR THE FIFTH CIRCUIT

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OPINIONS BELOW

The opinion of the Court of Appeals is not yet officially reported. It is unofficially reported at 29 AFTR 2d ¶ 72-679, p. 72-1408, and at 72-2 USTC ¶ 9494.

The findings and opinion of the United States Tax Court (the "Tax Court"), are not officially reported,

but are incorporated in a memorandum opinion, which is given the designation TC Memo 1970-182. They are unofficially reported at 29 TCM 817 and at 39 P-H Memo TC ¶ 70,182, p. 70-899.

The date of the judgment sought to be reviewed and the time of its entry was June 15, 1972. A petition for rehearing was timely filed and was denied on July 6, 1972. The statutory provision believed to confer on this Court jurisdiction to review the judgment in question by writ of certiorari is Title 28 Sec. 1254(1) U.S. Code (62 Stat. 928).

QUESTIONS PRESENTED

1. Whether unsubordinated purchase money notes issued by a corporation to persons who had no other interest therein should be treated as debt for the income tax purposes of the corporation and the guarantor of the notes, who was the constructive owner of its common stock, where the net assets available for the payment of such purchase money notes exceeded all of the unsubordinated debts of the corporation?

2. Whether purchase money notes issued by a corporation to persons who had no other interest therein, which were guaranteed by the constructive owner of its common stock and were subordinated to general creditors and to the unsubordinated purchase money notes, should be treated as debt for income tax purposes, when the amount thereof was not more than about four times the amount of common stock and the principal of debt subordinated thereto?

3. Whether an individual who is the substantial owner of the stock of a corporation, both of whom guarantee purchase money notes issued by another

corporation, is entitled to contribution from the corporate guarantor in determining the amount which shall be treated as a dividend to the individual guarantor?

STATUTES INVOLVED

The federal statutes involved in this case are copied in the appendices, pp. 25a-26a. All are parts of the United States Internal Revenue Code of 1954 (the "1954 Code"), and are Sections 163(a), 301(a) and (c)(1), 302(d), 316(a), and 317(b).

STATEMENT OF THE CASE

The facts which we believe are relevant to the questions above are stated below, based primarily on those stated in the opinion of the Court of Appeals. Most of the facts were stipulated and a substantial part thereof which are relevant to the issues is included in written documents, the authenticity of which was stipulated.

The case involves the income tax liabilities of Plantation Patterns, Inc. for its fiscal years ended September 30, 1963, 1964 and 1965 and of John S. Jemison, Jr. and his wife, Marie S. Jemison for the calendar year, 1963.

Two separate appeals to the Tax Court are involved in this petition, but they were consolidated for hearing and decision in the Tax Court and in the Court of Appeals.

Plantation Patterns, Incorporated, the corporate petitioner herein, hereafter generally called "New Plantation," is a corporation organized under the laws of Alabama under the name Plantpat, Inc. to acquire initially the stock, and thereafter the assets, of

another corporation of the same name. This is hereinafter referred to as "Old Plantation" (pp. 3a-5a).

$5,000 of the cash which was required by New Plantation to consummate the acquisition of the stock of Old Plantation and to supply additional working capital was paid in consideration of the issue of common stock to Mrs. Marie S. Jemison. $150,000 of such cash was paid to New Plantation in consideration of the issue of 6½% subordinated debentures (the "6½% debentures") to Bradford and Company, Inc., a corporation which was not otherwise related to the Jemisons or to the stockholders of Old Plantation (p. 6a).

Mrs. Jemison was the wife of John S. Jemison, Jr. ("Mr. Jemison"), and Mr. Jemison was the substantial owner of the stock of Jemison Investment Company, Inc. Mr. and Mrs. Jemison filed a joint federal income tax return for the taxable year which is here involved, and both are therefore included as petitioners.

Old Plantation was a corporation which had been engaged for several years in the manufacture of wrought iron furniture and metal office chairs. Jemison Investment Co. made an offer to Thomas E. Jernigan and other stockholders of Old Plantation for the acquisition of all of the stock of Old Plantation and the disposition of the metal chair business to its stockholders, which, after modification, was carried into effect. The consideration fixed for the acquisition of the stock of Old Plantation, excluding those parts thereof which were referable to the metal chair business, was the net figure of $709,878.33, of which amount $100,000 was paid in cash at the time of closing, and $609,878.33 was represented by 5½% serial notes (the "5½% notes"). These were payable in equal annual

installments of $50,000, beginning October 1, 1963 and continuing through October 1, 1972, with a final installment of $109,878.33 due on October 1, 1973 (p. 8a).

The first two installments of the 5½% notes, aggregating $100,000 principal amount, were not subordinated, but the remaining $509,878.33 principal amount thereof was subordinated to the payment of all of the debts of New Plantation, other than the 6½% debentures (p. 9a).

A copy of the 5½% note to Thomas E. Jernigan which is a part of the $50,000 principal amount due on October 1, 1963, is included as Appendix III. This also shows the guarantees. The subordination provisions of the 6½% debentures are included as Appendix IV, and those of the 5½% notes as Appendix V.

Forthwith after the stock of Old Plantation was acquired by New Plantation, Old Plantation was dissolved, and its assets were distributed to New Plantation. Footnote 6 to the opinion of the Court of Appeals contains findings as to the values of the assets of New Plantation which were based upon findings by the Tax Court. The Court of Appeals also stated that the consideration for the stock of Old Plantation was equal to its net worth plus $644,909.53. However, the balance sheet set forth in footnote 6 shows that the values of the assets of New Plantation included only $199,060.70 as good will and $42,463.31 for a long term lease, pp. 7a, 11a-12a.

The Tax Court included the following specific findings with respect to the payments made on the 5½% notes and the 6½% debentures:

> "During the period from October 1, 1962 to September 30, 1966, New Plantation otherwise duly

paid principal and interest as due on the 6½ percent debentures issued to Bradford and Co., Inc. and on the 5½ percent notes issued to the stockholders of Old Plantation. Said payments were made by New Plantation without recourse to any additional financing." Vol. 39, 1970 P-H Memo TC p. 70-903.

The Court of Appeals essentially adopted this finding, p. 10a. Old Plantation had been profitable during its corporate existence, and the Tax Court opinion includes the following findings with respect to the earnings thereof after all taxes and excluding income or loss of the Chair Division. These findings are not carried into the opinion of the Court of Appeals:

Year	Net Income (Loss)
1957	($ 1,096.83)
1958	7,533.75
1959	8,067.66
1960	19,737.69
1961	94,637.46
Total	$128,879.73

The earnings of Old Plantation for the nine months period ended on September 30, 1962 aggregated $92,-368.68 after provision for taxes on income.

Payment of the 5½% notes was guaranteed by both Jemison Investment Co. and Mr. Jemison. Mr. Jemison, acting through this corporation, had been very successful, and most of his net worth was represented by the value of the stock of that Company. Jemison Investment Co. was paid a fee of $15,000.00 per year for executing the guarantee, but no fee was paid to Mr. Jemison therefor. Mrs. Jemison was treated as

the nominee of her husband in respect of the acquisition of the stock and the determination of income tax liabilities. Fifty-five separate 5½% notes for each maturity and each stockholder of Old Plantation were executed by New Plantation. No principal payment on the 6½% debentures was due until 1974, p. 8a.

Upon audit of the returns of New Plantation for its fiscal years ended September 30, 1963, 1964 and 1965 and of the return of Mr. and Mrs. Jemison for 1963, the Commissioner of Internal Revenue disallowed a deduction for the interest accrued and paid by New Plantation on both the 5½% notes and 6½% debentures, and included payments of the principal of the 5½% notes due October 1, 1963, aggregating $50,000 in the taxable income of Mr. Jemison as a constructive dividend. The Commissioner also made initially other adjustments to the income of the Jemisons which were eliminated by the Tax Court and are not material to the issues presented here, pp. 10a-12a.

Following some comments made by the presiding judge of the Tax Court, the Commissioner changed his position with respect to the deduction of interest on the 6½% debentures and proposed to allow the deduction therefor. This reduced the judgment against New Plantation, and the Commissioner did not appeal from that favorable treatment. However, in the Court of Appeals, New Plantation agreed that this deduction might be disallowed if, in order to procure deductions for interest on the 5½% notes, the $150,000 principal amount of the 6½% debentures were required to be treated as "equity" in computing the debt-equity ratio. This agreement is renewed here.

Here, we use the term "equity" in the non-technical sense in which it is used in dealing with the debt-equity ratio principles, and as is done in this

case in respect of the principal of the 5½% notes. In computing the debt-equity ratio, we eliminate the three non-interest bearing notes which total $183,435.84, since they were due to be paid with the proceeds of the sale of the United Chair Division to the stockholders of Old Plantation for a like amount. This sale was consummated forthwith after the liquidation of Old Plantation, and the notes were paid when due in 1963, pp. 9a-10a.

The only payment of principal of the 5½% notes which affects the income tax liability of the Jemisons for 1963 was the payment of a total of $50,000 on October 1 of that year which was a part of the unsubordinated portion of such notes. However, the interest disallowance to New Plantation related to all of the 5½% notes.

For the purposes of one finding, the assets of New Plantation should be stated as follows:

Fair market value of assets per balance sheet in footnote 6 to opinion	$1,261,327.81
Less: assets in United Chair Division included in accounts receivable	183,435.84
Fair market value of assets retained by New Plantation	$1,077,891.97

To offset this total, the liabilities may be stated as follows:

Debts owed to general creditors	$ 313,013.64
Unsubordinated 5½% notes	100,000.00
Partially subordinated 5½% notes	509,878.33
Fully subordinated 6½% debentures	150,000.00
Common Stock	5,000.00
	$1,077,891.97

Thus, the $100,000 principal amount of unsubordinated 5½% notes was entitled to share equally with the other general creditors ($313,013.64) in the assets of New Plantation having a fair market value of $1,077,-891.97 and had *priority* over $659,878.33 of junior debt and $5,000 of common stock, $664,878.33 in the aggregate.

Following the Tax Court largely, the Court of Appeals includes several different statements about the debt-equity ratio. One is of the import that New Plantation had tangible assets at fair market value of approximately $1,064,000 securing "debts" of approximately $1,078,000, p. 21a. The calculation of the latter amount is shown above. It includes $5,-000 of common stock, an obvious mathematical error. The reduction of the asset account by $14,000 below the liabilities account is not explained by either court and the petitioners have not found the reason therefor.

Immediately preceding the foregoing statement, the Court of Appeals states that New Plantation's "quick assets (cash and accounts receivables)" of $317,000 could not cover its current liabilities of approximately $490,000. These amounts include the $183,435.84 agreed to be paid for the United Chair Division as accounts receivable and a like amount of part of the current liabilities. The comparison between "quick assets" and current liabilities is a harsh one and ignores the fact that the fair market value of inventories was found to be $228,376.12 in said footnote 6. The omission of the inventories from the comparison is material in respect of the reference to the Tax Court finding that the assets of New Plantation vis a vis its debts were insufficient to give New Plantation "viable independence as a corporation." Actually, New Plan-

tation acquired all the assets which had enabled Old Plantation to make over $90,000 per year in the wrought iron furniture business, pp. 11a, 21a.

REASONS FOR GRANTING THE WRIT

1. **1. In holding that the debt-equity ratio was too high in respect of the $50,000 principal amount of 5½% notes that was due and paid on October 1, 1963, the decision of the Court of Appeals on an important question of Federal law is in direct and irreconcilable conflict with the decision of the Court of Appeals for the Second Circuit in Kraft Foods Co. v. Commissioner, 232 F.2d 118, the decision of the Court of Appeals for the Ninth Circuit in Murphy Logging Co. v. United States, 378 F.2d 222, and cases in the Tax Court.**

This is believed to be a case of first impression in this Court in that it does not involve the question of the payment of interest on advances or loans by stockholders to their corporation, but the consequences of a guarantee by a constructive stockholder of the indebtedness of the corporation to unrelated third parties. The Court of Appeals assumed, without stating reasons therefor, that this case involves the so-called debt-equity ratio principle, and initially we deal with the case on that basis.

The $50,000 principal amount of 5½% notes that matured on October 1, 1963, is the only part thereof which is involved in the case of the Jemisons. However, in stating the debt-equity ratio, we recognize that account must be taken of the entire $100,000 principal amount of unsubordinated 5½% notes. The fact that separate notes were given for this maturity and that of October 1, 1964 eliminates any justification for agglomerating them with the subordinated portion of the notes, although this appears to be the only theory on which the Court of Appeals proceeded in dealing with the subordinated 5½% notes, cf., *St.*

Louis Union Trust Co. v. *Champion Shoe Machinery Co.*, 109 F.2d 313 at 316 (8th Cir., 1940), pp. 5, 7 herein and pp. 8a, 9a in the Appendices.

If, as we undertake to demonstrate under reason 2, effect is to be given to the consensual subordinations of some of the 5½% notes and of the 6½% debentures, the debt-equity ratios are very different from those which are stated in the opinions of the courts below. In the case of the unsubordinated 5½% notes, the equity, including the $659,878.33 of debts which were subordinated thereto, was initially $664,878.33, not the $5,000.00 mentioned in the opinion of the Court of Appeals. Normally, in stating the debt-equity ratios, only long-term debt is considered, and the Court of Appeals generally treated it that way.

This would then be only $100,000, and the ratio would then be 1 to 6.6. Even if liabilities to other general creditors were added, making it $413,013.64, the ratio would be 4.1 to 6.6, or about 2 to 3.

In *Kraft Foods Co.* v. *Commissioner*, 232 F.2d 118 (2nd Cir., 1956), the debt was $30,000,000 and the equity was $39,000,000, a ratio of 10 to 13. The Court there held there was no "thin capitalization." The ratio in *Murphy Logging Co.* v. *United States*, 378 F.2d 222 (9th Cir., 1967), is not made clear, but certainly the equity did not exceed the debt. In fact, there is no case of which we are aware in which a corporation has been held to be thinly capitalized in which the equity exceeded the debt, and we believe there is none which is referable solely to the debt-equity ratio. No guarantee was involved in *Kraft Foods*, but in *Murphy Logging*, the stockholders did guarantee the debt in question. The conflicts here noted should, we

submit, influence the Court to grant the writ, and reverse the Court of Appeals.

To the extent to which *John Kelley Company* v. *Commissioner,* 326 U.S. 521 (1946) is authoritative at all since it applied the rule of *Dobson* v. *Commissioner,* 320 U.S. 489 (1943), it corresponds with *Kraft Foods Company,* in that the equity exceeded the debt substantially.

This should dispose of the case for the Jemisons. But no interest on any of the 5½% notes was allowed as a deduction. So, the status of the subordinated notes must be also dealt with. Here, the direct conflict is with *Murphy Logging* alone, though this extends to the valuation question also.

The debt-equity ratio, as generally computed, is slightly less than 4 to 1 in the case of the subordinated 5½% notes—$609,878.33 of debt to $155,000.00 of equity—including, as equity, the principal amount of the 6½% debentures. Neither the Tax Court nor the Court of Appeals treated the case as involving such a ratio, erroneous as was this failure. The presiding judge of the Tax Court intimated that if the 6½% debentures were treated as equity, New Plantation was not thinly capitalized. As we read the opinion, the Court of Appeals agreed:

> ". . . If these notes are regarded as equity, taxpayers argue that the debt-equity ratio of New Plantation would be approximately 4 to 1 ($609,878.33 to $155,000), and not the plus 125 to 1 ratio which the government asserts is the proper debt-equity ratio ($759,878.33 to $5,000). *This would effectively demolish the Tax Court finding of thin capitalization.*" (emphasis supplied, p. 18a)

That we correctly interpret the last sentence is indicated by the fact that the 6½% debentures were

treated as debt in arriving at a ratio of 150 to 1—$759,878.33 to $5,000 (erroneously stated to be 125 to 1). The Court of Appeals really accepted this position, since the holding that the debentures evidenced a loan was affirmed (pp. 18a, 23a).

For a case in which the Tax Court first determined that certain stockholder loans were equity and then concluded that certain other debt guaranteed by stockholders was debt because, after treating the stockholder loans as equity, the corporation was not thinly capitalized, see *J. Paul Smyers,* 57 T.C. 128 (1971).

Differences about the proper debt-equity are not the only conflicts between the decision of the Court of Appeals below and those in *Murphy Logging* and *Kraft Foods.* They are also opposed in the approaches toward valuation of businesses and the significance of prior earning power and established businesses. In this area, the opinion expressly concedes conflict with the Ninth Circuit in *Murphy Logging,* pp. 22a, 23a.

In substance, the Court of Appeals says that no value is to be assigned to "management skills and normal business contacts," since they are expected of "management in the direction of any corporation," p. 23a. But not every management has them in adequate degree, or there would be no, or fewer, insolvencies and unsuccessful business enterprises. The ability of stockholders to procure profitable contracts was the predicate for the conclusion on valuation in *Murphy Logging.* This gave assurance of future earning power (based on past experience) which would enable that corporation to function.

Recognition of going concern value is general, if not universal, in the business community. It was given

effect in *Kraft Foods* in the statement that earning power demonstrated in prior years, assured debt service (232 F.2d 122). In this case, the Court of Appeals rejects later success as a significant factor. But the record and findings of the Tax Court also show prior earnings that would give some assurance of continued profitable operations sufficient to service the debts actually assumed, as they fell due. This was a fact that was known at the inception of the business and no doubt influenced the decision of knowledgeable investors involved to pay the agreed price in an arm's length transaction. The facts about earnings are stated on p. 6.

Here, we call attention to them to show the conflicts. The conclusion of the Court of Appeals on this question is also in direct conflict with the decisions of the Tax Court in *Baker Commodities, Inc.,* 48 T.C. 374 at 397 (1967), and in *George A. Nye,* 50 T.C. 203 at 215 (1968). This Court held that subsequent events were proper evidence in this area in *Sinclair Refining Co.* v. *Jenkins Petroleum Process Co.,* 289 U.S. 689 at 697 (1933).

Ainslie Perrault, 25 T.C. 439 at 450-1 (1955), is especially significant because of the Commissioner's acquiescence therein (1956-1 Cum. Bul. 5).

In ultimate reliance on *Sinclair Refining Co.,* the first two Tax Court cases take account of later earnings in appraising going concern value. So do *Nachod & U.S. Signal Co.* v. *Helvering,* 74 F.2d 164, 168 (6th Cir., 1934) and *Tex-Penn Oil Co.* v. *Commissioner,* 83 F.2d 518 (3rd Cir., 1936) in other phases of the income tax law. Taxable income of New Plantation for its fiscal years 1963, 1964 and 1965 is in evidence as a

part of the government's case to fix the deficiencies, and proof of payment of the 1963 installment of 5½% notes is the predicate for the deficiency assessed against the Jemisons. Both the Tax Court and the Court of Appeals expressly found that all obligations on the 5½% notes and the 6½% debentures had been met through September 30, 1966, without recourse to additional financing. The amounts of interest involved are also stated (p. 10a).

Nevertheless, in spite of this finding and the conflict with the foregoing authorities, the Court of Appeals said it did not regard as significant the fact that ultimately things progressed smoothly, and that New Plantation met its obligations. The reason assigned was that the issue was whether "at its inception" there was a reasonable prospect that "the business would succeed on its own" (p. 22a). We do not see how, in the face of the foregoing authorities, the Court of Appeals could, in the valuation area, and in the determination whether New Plantation would have "viable independence as a corporation," (p. 18a) refuse to attribute significance to facts that are inherently a part of the record for other purposes.

In *Kraft Foods,* the Court stated that earnings continued to be good in the taxable years at issue, but does not indicate what effect, if any, was given thereto (232 F.2d 121). But there was certainly reliance on past earnings (232 F.2d 122).

As a matter of fact, it is almost inescapable that in finding that the 6½% debentures constituted a true loan, both courts below were substantially influenced by the fact that New Plantation paid the interest on and principal of the 5½% notes and the 6½% debentures as they matured. In numerous instances, the

courts take cognizance of extensions of payment and other indulgences in finding that advances by stockholders to their corporation constitute equity rather than debt. On the other hand, compliance with the requirements of the controlling documents support the treatment as debt, e.g., *Harlan* v. *U.S.*, 409 F.2d 904 (5th Cir., 1969).

While relying on the authority of the foregoing cases as to the materiality of subsequent earnings and debt history, we also meet the Court of Appeals on its own grounds, and show that its ultimate findings are in conflict not only with *Kraft Foods, Murphy Logging,* and the Tax Court cases just cited, but also with decisions of this Court. After a short life, Old Plantation had realized earnings, net after taxes, of $94,637.46 in 1961 and $92,368.68 in the first nine months of 1962. Even after taking account of additional interest and depreciation charges, these were sufficient to service the 5½% notes and 6½% debentures. See p. 10a.

The Tax Court cases involved obligations of a corporation to its stockholders, and so are direct authorities essentially in line with *Kraft Foods.* They are also debt-equity cases in which going-concern value was considered, as in *Murphy Logging.*

The predicates for the express refusal of the Court of Appeals to follow *Murphy Logging* and the objections thereto by the Tax Court and the Commissioner, noted on pp. 17a and 19a, are directed at the business contacts and financial skills of Mr. Jemison, and do not take account of the demonstrated earning power of the business which was acquired by New Plantation from Old Plantation. The expectancy of "future custom" (as it is in *Murphy Logging*), as well as competency

of management, was an asset vested in New Plantation, as indicated by past earning power. If continued, this was sufficient to assure service of the purchase money debt assumed by New Plantation.

The failure of the Court of Appeals to take account of the value of earning power does not accord with decisions of this Court in numerous cases, of which we cite only two, *Commissioner* v. *Clay B. Brown*, 380 U.S. 563 (1965) and *Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc.* v. *Anderson*, 390 U.S. 414 (1968). In *Clay B. Brown*, this Court sustained a transaction as a sale at a large price over book value because it was indicated that prospective earnings would be sufficient to pay the sale price. The government abandoned a contention that the transaction was a sham. 380 U.S. at 569. This is pertinent here on another point, p. 40.

In *TMT Trailer Ferry, Inc.*, this Court restated the principle that, in reorganizations under the Bankruptcy Act, an estimate must be made of prospective earning power and held further that the determination thereof need not be based on past earning power alone. Indeed, the reversal was based largely on the trial court's failure to give effect to factors that indicated that earning power in the future might be better than in the past. (390 U.S. at 452 and 453)

This case involved implicit applications of the principles that a lower court should be reversed if it does not apply proper standards to the facts or if it fails to take adequate account of all the evidence, and especially findings, that should be considered in arriving at a proper judgment. *United States* v. *Parke, Davis & Co.*, 362 U.S. 29, 44 (1960) asserts the first principle. *New York Central & H.R.R. Co.* v. *Beaham*,

242 U.S. 148 (1916), holds that a court may not arbitrarily disregard evidence.

This is also implicit in *Helvering* v. *Tex-Penn Oil Co.*, 300 U.S. 481 at 491 (1937). There, as in other cases, this Court also uses express findings of "primary" facts by the trial court in arriving at its conclusions of "ultimate" facts. The facts stated by the Court of Appeals here adequately show the pertinent subordinations and the fact that the notes and the debentures were serviced (pp. 6a, 9a and 10a).

Proper consideration of going-concern value supplies part of the answer to the statement that only "$5,000 was set up as equity to finance launching of the corporate venture" (p. 20a), and the repetition of the Tax Court finding that the corporate assets were wholly inadequate to sustain a debt of $609,878.33, p. 19a. These overlook or ignore the fact that an active business was continued under new ownership, as well as the function of the $150,000 of cash supplied by the holders of the subordinated 6½% debentures.

The Court of Appeals repeats this error in the next paragraph on p. 20a dealing with "other supposed equity-factors" in a reference to the claimed "meager capital position" of New Plantation. We urge that these failures to give proper consideration to the undisputed evidence about earning power and the significance of subordinated "capital" require reversal, *New York C. & H. R. R. Co.* v. *Beaham*, and *U.S.* v. *Parke, Davis & Company*.

We do not mean to exclude the possibility that the business might not have been sufficient to service the 6½% debentures. However, in the event of a default thereon, the holders might acquire the business, but

this would not adversely affect the ability of New Plantation to meet all of its obligations on the 5½% notes.

2. In failing to give effect to the consensual subordinations of $509,878.33 principle amount of the 5½% notes and $150,000 principal amount of the 6½% debentures in determining the applicable debt-equity ratios, the decision of the Court of Appeals is in conflict with the decision of the Court of Appeals for the Second Circuit in the case of In re Credit Industrial Corporation, 366 F.2d 402, with decisions in five other circuits, and with United States v. Key, 397 U.S. 322 (1970).

In this case, we are, in fact, concerned with three debt-equity ratios, (1) with respect to the $100,000 principal amount of 5½% notes that were unsubordinated, (2) with respect to the $509,878.33 subordinated 5½% notes, and (3) with respect to the 6½% debentures. While each is obviously different in determining whether or not there is thin capitalization, the Court of Appeals did not recognize that there was any difference in comparing debts of approximately $1,078,000 with assets of $1,064,000 "at fair market value," p. 21a.

The derivation of these figures is shown above, p. 8.

It is implicit in the opinions of both lower courts that the debt-equity ratio is only relevant in determining whether, after taking account of the claims of other creditors, there is a reasonable prospect that the debt in question can be paid. This requires a comparison of asset values with such debt and other debts having the right to participate in those assets. Since, by express provision therein, the 6½% debentures were subordinated to all other debts, they are to be excluded from the debts that are to be compared with the 5½% notes (App. IV, p. 6a).

The reasons for execution of such subordination agreements which are relevant here and support the foregoing contention are well stated in the opinion in *Austin* v. *National Discount Corporation*, 322 F.2d 928 (4th Cir., 1963). After stating that lending banks in deciding what amount they will lend, relied to a large extent on the amount of "capital" and that, in determining such amount, these banks include subordinated long-term indebtedness, the Court proceeds:

> "This is based on the realization that the sale of such subordinated debt, as does the sale of capital stock, swells the amount of assets of the finance company available for operating use without increasing the amount of debt that will share the available assets on a parity with the banks in the event of bankruptcy." (322 F.2d 929)

Furthermore, in the case of the $50,000 of 5½% notes that were due and paid on each of October 1, 1963 and 1964, the remaining $509,878.33 principal amount of such notes that was subordinated to such $100,000 should be excluded.

The Tax Court and the Court of Appeals refused, or failed, to give effect to these provisions for consensual subordination in several respects in treating the debts as $1,078,000, namely: (1) in stating that the assets were wholly inadequate to sustain a debt of $609,878.33 rather than just $100,000, as to the unsubordinated portion; (2) in stating that only $5,000 was set up as equity; and (3) in holding that the $150,000 principal amount of 6½% debentures was debt though subordinated to all the 5½% notes (pp. 19a, 20a, 21a, 23a).

In failing to give effect to such consensual subordination agreements, the decision of the Court of Ap-

peals is in irreconcilable conflict with the decision of the Court of Appeals for the Second Circuit in the case of *In re Credit Industrial Corp.*, 366 F.2d 402, 408-9 (2nd Cir., 1966), and other authorities cited in Calligar "Subordination Agreements," 70 Yale L.J. 376-404 (1961). This article demonstrates the usefulness of the subordination device in corporate financing. See also *Collier on Bankruptcy* § 65.06. The other authorities, most of which are cited in the Calligar article, include the following decisions of five Courts of Appeal:

St. Louis Union Trust Co. v. *Champion Shoe Mach. Co.*, already cited, a decision of the 8th Circuit

Bank of America National Trust & Savings Asso. v. *Erickson*, 117 F.2d 796, 798 (9th Cir., 1941)

In re Dodge-Freedman Poultry Co., 148 F.Supp. 647, aff'd on opinion below, 244 F.2d 314 (1st Cir., 1957)

Austin v. *National Discount Corp.*, just cited

In re George C. Bruns Co., 256 Fed. 840, 841 (7th Cir., 1919)

United States v. *Key*, 397 U.S. 322, 327 (1970) is in essential accord with those decisions of the Courts of Appeal. It is discussed on pages 26 and 33.

Indeed, it is entirely anomalous to treat the 6½% debentures as debt though subordinated to the 5½% notes and in treating those notes as involving a contribution to capital. This inconsistency in the decision of the Tax Court should have been alone enough to require reversal by the Court of Appeals. The perpetuation of it should be sufficient to require reversal of the Court of Appeals by this Court. To that extent, the two judgments are arbitrary and without rational foundation and are therefore not entitled to the bene-

fit of a presumption in their favor. This Court has so held in the case of conclusions by the Commissioner. *Helvering* v. *Taylor,* 293 U.S. 507 (1935). See also *The Lottawanna,* also styled *Wilson* v. *Bell,* 20 Wall. (87 U.S.) 201, 217 (1874) and further discussion in the argument, pp. 32-5.

In dealing with the status of the 6½% debentures, the Court of Appeals said that subordination is far from the "sole criterion" for determining whether an interest is debt or equity. This purported answer is merely begging the question, for it is the status of the 5½% notes which is at issue, not that of the 6½% debentures. Subordination alone prevents the holders of the 6½% debentures from participating with holders of the 5½% notes in assets of New Plantation. Therefore, in ascertaining the debt-equity ratio for the 5½% notes, in determining the deductibility of interest thereon, it is immaterial whether the debentures are treated as debt or equity. See *Austin* v. *National Discount Corp.* where cited on p. 20.

3. The decision of the Court of Appeals in this case is in conflict with the decision of the Court of Appeals for the Ninth Circuit in Murphy Logging Company v. United States, 378 F.2d 222 (1967), and with the decisions of the United States Tax Court in Arthur J. Kobacker, 37 T.C. 882 (1962), and Santa Anita Consolidated, Inc., 50 T.C. 536 (1968), on an important question of federal income tax law in treating the 5½% notes issued by the New Plantation as equity for income tax purposes because they were guaranteed by Mr. Jemison, the constructive owner of New Plantation's common stock, just as the owners in Murphy Logging had guaranteed such debts.

For various reasons, including the effects of a total recasting of the transaction, the Court of Appeals did not undertake to justify its treatment of a guarantee in the same way that it treats direct advances by

stockholders to the corporation. Yet, there are important differences between the relationship of a direct creditor of a corporation and a guarantor of its indebtedness to a third person. In the case of a direct creditor, he receives amounts paid as interest and as principal.

In the case of a guarantee, the payments to the principal debtor merely reduce the exposure of the guarantor to the necessity for payment of the debt if the principal debtor defaults in such payment. The guarantor is only contingently liable and does not receive any property or money to constitute income. This Court has, we believe, never passed on this question and in *Murphy Logging,* the government conceded that it was probably the first of its kind. There is no decision like those of the courts below, except that of the trial court in *Murphy Logging.*

A guarantee creates different relationships and obligations from those of a direct advance. In this case, the guarantors would not be liable to other general creditors of New Plantation, who held some $313,500 of debt, and they would participate with them, on subrogation principles, if required to pay the unsubordinated notes. Section 87 of Title 9 of the Code of Alabama of 1940.[1] The Tax Court treated Mr. Jemison as the primary obligor with respect to the 5½% notes, stating that the guarantee was an indirect contribution of capital. The Court of Appeals states that Mr. Jemison's guarantee was "an obligation primary

[1] Sec. 87 of Tit. 9 reads:

"§ 87. Subrogation.—A surety who has paid the debt of his principal is subrogated both at law and in equity, to all the rights of the creditor, and in a controversy with other creditors, and in a controversy with other creditors, ranks in dignity the same as the creditor whose claim is paid."

in nature" (pp. 12a, 19a). In *Murphy Logging Company,* the Court of Appeals for the Ninth Circuit declined to recast or, as it says, "collapse" the transaction. The argument contains comment on the "indirect contribution of capital" (p. 42).

To treat Mr. Jemison as the primary obligor means that he was the purchaser of the stock of Old Plantation and contributed that stock to New Plantation. In that case, the liquidation of Old Plantation would not give the benefit of § 334(b)(2) of the 1954 Code to New Plantation. § 334(b)(3)(C) of the 1954 Code. The Tax Court was inconsistent in giving New Plantation basis related to the purchase price and in calling Mr. Jemison the purchaser.

Guarantee of corporate debts by stockholders is a common practice and is commonly required in the case of closely held corporations. This is expressly recognized in the opinion of the Tax Court (¶ 70, 182, 39 P-H Memo TC p. 910-70). There are reasons for requiring a guarantee aside from the credit factor.

Businessmen and bankers are very much interested in knowing whether, in the case of a guarantee by a stockholder, payments by a corporate debtor of interest and principal are to be treated, for income tax purposes, differently from the intention of the parties, irrespective of intention, where it is plain that the corporation involved is the principal debtor. It would greatly disturb banking relationships and impair the borrowing power of small corporate businesses if the execution of a guarantee by its stockholders is to have the double taxation effects which are imposed in the cases at bar.

Insofar as recasting the transaction is concerned, other parties than the corporation and guarantor are

involved. Here, the stockholders of Old Plantation were given claims against New Plantation, as principal debtor, and it is quite clear that they had no intention of releasing those claims in reliance solely upon the guarantee. So, where the creditor looks to both the named principal debtor and the named guarantor, the business community needs to know whether the form of the transaction is always to be disregarded, or, if not, then in what situations that is to be the case. If so-called thin capitalization is to influence the ultimate conclusion, we submit that it should be made known authoritatively. In the present state of the decisions on the subject, only this Court can speak with the necessary finality.

4. In failing to assign a separate classification to the unsubordinated 5½% notes, the decision of the Court of Appeals is in essential conflict with the decision of the Court of Appeals for the Eighth Circuit in St. Louis Union Trust Company v. Champion Shoe Machinery Company, 109 F.2d 313 (1940) and with the decision of this Court in United States v. Key, 397 U.S. 322 (1970).

The decision in *St. Louis Union Trust Company* is cited above in support of the contention that the unsubordinated 5½% notes should not be agglomerated with the subordinated 5½% notes in determining the debt-equity ratio. That case involved bonds which had specific maturities. In connection with extensions of those maturities, some of the holders of the bonds also agreed that they should be subordinated to other debts of the corporate debtor. It was held that the bonds which were not subordinated reserved rights sufficiently distinct to entitle them to separate classification in the distribution of the assets of the bankrupt debtor. The Court said:

> "We think that the appellants' rights were sufficiently distinct from those of other bondholders

to entitle the appellants and those who were similarly situated to a separate classification." 109 F.2d 316.

The Court of Appeals recognized that $100,000 principal amount of the 5½% notes were unsubordinated, but did not treat the subordinated 5½% notes as the equivalent of capital in the determination of any debt-equity ratio. This is in addition to the failure to treat the 6½% debentures as equity in that determination. Under *St. Louis Union Trust Company,* as well as other cases, it is clear that, in the event of bankruptcy, the subordination agreements would be given effect. Therefore, the decision of the Court of Appeals is in irreconcilable conflict with the Eighth Circuit on this point.

St. Louis Union Trust Co. and others of like import which are cited on p. 21 apply equitable principles to the distribution of assets in bankruptcy proceedings. This is in accord with significant decisions in this Court concerning reorganizations, both in receiverships and in proceedings under the Bankruptcy Act. The original cases dealt with the need for preferring creditors over stockholders, and secured creditors over general creditors under general principles or a statute which specified that the plan of reorganization must be "fair and equitable."

However, there is a case which did not involve secured creditors, but the United States, which was held to have a statutory priority in the distribution of the assets of a bankrupt estate. In *United States* v. *Key,* this Court held that a plan of reorganization which did not give full effect to that priority, treating it, in substance, as constituting a separate class, would not be

permitted, and that the plan must be reframed to accord the United States its full priority rights.

In failing to treat the holders of the 5½% unsubordinated notes as constituting a separate class, entitled to full priority over debt subordinated thereto, as well as stock, the Court of Appeals rendered a decision that is wholly irreconcilable with *United States* v. *Key*.

5. In undertaking to recast the transaction so as to impose on Mr. Jemison supposedly the primary obligation for the payment of the 5½% notes, the decision of the Court of Appeals ignores economic realities and the express provisions of unimpeached documents in such manner as to conflict, essentially, with the principles that are applicable in disregarding the form of a transaction which are declared and applied in cases like the decision of the Court of Appeals for the Third Circuit in Tex-Penn Oil Company v. Commissioner, 83 F.2d 518 (1936), and decisions of this Court in Helvering v. Tex-Penn Oil Company, 300 U.S. 481 (1937), and U.S. v. Cumberland Public Service Co., 338 U.S. 451 (1950).

Unlike cases involving advances or sales to a corporation by one or more of its stockholders, the guarantee situation involves the rights of third parties which not only cannot be disregarded but which require some consideration for their interests in undertaking to establish that the substance of the transaction differs from its form. In this case, the Court of Appeals and the Tax Court necessarily recognized that the sellers of the stock of Old Plantation intended to and did receive obligations of New Plantation which were payable in all events, at fixed times over a term of years, with an established rate of interest and contained other attributes which are common in the case of debts, but did not reserve to the holders any right to vote or participate in management or contain any other attributes of stock, unless partial subordination

of a portion of the 5½% notes be deemed such a deviation from the characteristics of an instrument purporting to create a debt.

This was expressly recognized in the opinion in the Tax Court which conceded that the 5½% notes were "entirely conventional in form rather than hybrid securities, with some of the characteristics of an equity issue . . ." (¶ 70,182 P-H Memo TC, pp. 908-70). The opinion of the Court of Appeals is not so specific, but there is a clear recognition of the right of Old Plantation stockholders to collect the 5½% notes that were given to them, possibly most distinctly in the description of Mr. Jemison's guarantee as "an obligation primary in nature." (p. 20a)

If we should concede the right to recast the transaction to any extent whatever, the Courts should surely be guided by economic realities and by what was done, and not be permitted to ignore those aspects of the transaction in order to increase the total tax liabilities of all parties to the United States, irrespective of the true nature of the transaction.

The preference of Mr. Jemison as the primary obligor in lieu of Jemison Investment Company completely ignores economic realities in the circumstances of this case. The Tax Court found, and the Court of Appeals incorporated that finding in the statement that it was uncontested that "practically all of Mr. Jemison's assets consisted of stock in Jemison Investment Company." (p. 24a). In those circumstances, a direct obligation of a corporation is undoubtedly of greater value than that of a stockholder who would meet his obligations on a guarantee by receipt of dividends from that corporation.

In addition, Jemison Investment Company received a fee of $15,000. This reason for finding that it should be the primary obligor rather than Mr. Jemison is disregarded, because it is said that Mr. Jemison could control what was done and on a statement that the guarantee was either a matter of internal accounting or for cosmetic effect. The assignment of those reasons for disregarding a conceded fact and for stating that it did not supply an indication that the sellers of Old Plantation "realistically looked to Jemison Investment Company for any security" ignores any effect of that fee upon the holder of the 6½% debentures.

In any event, to find that the holders of the guaranteed obligations did not look to the financially stronger of the two guarantors carries the doctrine of looking to substance rather than form to extremes that are wholly inconsistent with the authorities which deal with that question. There is no justification whatever for concluding that the guarantee by Jemison Investment Company was a sham. Rather, it is proper to infer that the guarantee of Mr. Jemison was added to that of the Investment Company, because it is normal to expect guarantees of obligations incurred by closely held corporations. The conclusion to disregard the Jemison Investment Company guarantee is inconsistent with the recognition of that common business practice which was recognized in the opinion of the Tax Court itself, 39 P-H Memo TC ¶ 70,182, p. 70-910.

6. In failing to find that Mr. Jemison was entitled to contribution from Jemison Investment Company in respect of any payment that he might make pursuant to his guarantee of the 5½% notes, the decision of the Court of Appeals is in direct conflict with the decision in Phillips-Jones Corporation v. Parmley, 302 U.S. 233 (1937).

Even if the Court should not be satisfied that Jemison Investment Company was the primary obligor on the guarantees, it was certainly obligated jointly with Mr. Jemison and therefore would be required to respond equally with him. The basic principle arises under general law and was applied in *Phillips-Jones Corporation* v. *Parmley*, 302 U.S. 233 (1937). It is there said that, in an action for contribution, the plaintiff must prove that there was a common burden of debt (here based on guarantees by two different guarantors) and that he has as between himself and the defendants paid more than his fair share of the common obligations. The case involved the rights of a transferee from whom the entire tax was collected to contribution from the other stockholder transferees. The opinion of this Court includes the following sentence:

> "The injustice of allowing the other stockholders to escape contribution is obvious." (302 U.S. 235)

The common law on this subject is carried into Sec. 85 of Title 9 of the Code of Alabama of 1940 which, as amended, reads:

> § 85. Contribution.—All the foregoing provisions shall apply to cases where there are more than one surety, so as to enable a surety discharging a joint debt, in whole or in part, either pending the action or after joint or several judgments, to control the same against his cosureties for the purpose of compelling them to contribute their respective shares of the amount so paid by him."

Under this statute and the underlying law declared in *Phillips-Jones Corporation*, Jemison Investment Company is the primary obligor with respect to at least one-half of any payment which would be required under the guarantees. It is inappropriate and unjust to treat relief from the burden of paying that one-half as a constructive dividend to Mr. Jemison. Although we raised this question, the Court of Appeals did not even state the issue.

ARGUMENT

The Inconsistency in Treatment of the 6½% Subordinated Debentures and the 5½% Notes by the Courts Below in a Case of First Impression Requires Reversal.

So far as the petitioners know, the decisions below are the first cases in which a guarantor has been held to receive constructive dividend income upon payments to the creditor by the principal debtor, at the appellate level. A decision of that import by the trial court was reversed in *Murphy Logging Company*, and that is the only case at the appellate level of which we are aware. Several decisions in the Tax Court support the positions of the petitioners herein. They include *Arthur J. Kobacker, Santa Anita Consolidated, Inc.* and *J. Paul Smyers*.

The number of business transactions which might be affected by decisions of the import of that of the Court of Appeals in this case is truly incalculable, because so often loans to corporations, especially relatively small corporations, are required to be guaranteed by one or more stockholders. This guarantee is not necessarily supplied for credit reasons but often merely to forestall dissipation of the corporation's assets.

It is, therefore, important that this Court establish a basic policy which would not only resolve the conflict

between the Fifth Circuit, on the one hand, and the Ninth Circuit and the Tax Court on the other, but would also inform creditors and stockholders whether they may expect double taxation when a guarantee is required and given in all cases, or even in a limited number thereof. Furthermore, there is a wide range of views about what is a proper debt-equity ratio. The business community needs to know what may be expected in this area.

We feel free to speak of this case as one of first impression in this Court, as *John Kelley Co.* did not involve a guarantor and was decided under the *Dobson* rule. Insofar as it is an authority, it appears favorable as to treatment of the 5½% notes as debt. Independent of the guarantee, there seems to be no doubt that they would qualify as evidencing debt rather than stock according to the standards applied in *John Kelley Co.* The opinion of the Tax Court implicitly concedes this, and the Court of Appeals apparently concurs. (pp. 13a, 20a; 39 P-H Memo TC ¶ 70,182, p. 908-70[2])

The most striking, indeed singular, aspects of the decision of the courts below are the inconsistent dealings with the effects of subordination and the inconsistent and anomalous holding that the 6½% debentures, though subordinated to all of the 5½% notes, evidence debt, while all of the 5½% notes, though some were not subordinated to any debt, and all of them had priority over the 6½% debentures, constituted equity. We conceive this to be an altogether incredible result. Yet, it appears to be responsible for several of the

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[2] On pp. 13a and 20a, in dealing with this specific point, the Court of Appeals refers to the 5½% notes as "debentures." In other places, this is done also with some resulting confusion.

predicates on which the conclusion is based that the 5½% notes did not represent debt.

For example, the conclusion that New Plantation was thinly capitalized is based upon statements that it had tangible assets of approximately $1,064,000 securing debts of approximately $1,078,000, and that "only $5,000 was set up as equity to finance launching of the corporate venture" (pp. 21a, 20a). The $1,078,000 of debts includes the $5,000 of capital stock, and the $150,000 principal amount of the 6½% debentures.

As to the 6½% debentures, there can be no reasonable doubt that they constituted "equity" or "capital" in respect of the 5½% notes because of the provisions for consensual subordination, that are incorporated therein. App. IV, p. 32a. This is made clear by the authorities in support of Reason 2, pp. 20-1. Of these cases, *St. Louis Union Trust Company* and *Austin* v. *National Discount Corporation* contain the most useful comments. Since it is a decision of this Court, *United States* v. *Key* is the most significant authority. Surely, in determining the amount of "capital" or "equity" which is available for the payment of a particular debt, the effects of a subordination which is created by a statute giving priority to a creditor cannot differ from those of a consensual subordination.

We urge that the bankruptcy cases are relevant, since the ultimate issue is whether there was a reasonable prospect that the 5½% notes would be paid as they matured. Priorities in bankruptcy proceedings might well determine this.

The statement that only $5,000 was set up as equity to finance launching of the corporate venture is only correct in the event that one disregards the subordina-

tion of the 6½% debentures and the receipt of the $150,000 therefor. In its context, the statement is most certainly misleading and, based on the authorities cited, it is essentially incorrect, as a matter of law (p. 20a). Nevertheless, conclusions like these appear to be the reasons why the Court of Appeals never deals, in terms, with the question of what debt-equity ratio is proper in these circumstances.

This anomalous treatment is accompanied by a correspondingly inconsistent treatment of the effects of subordination. In dealing with the 5½% notes, the Court of Appeals emphasized the fact that the sellers "considered financially acceptable an agreement to subordinate the great majority of the 5½% debentures (sic) to almost all other corporate indebtedness. . . ." (p. 20a) But in the case of the 6½% debentures, the Court of Appeals says that subordination is far from the sole criterion "in determining whether an interest is debt or equity. . . ." and adds that "aside from this single factor, this record is productive of nothing to indicate that this was not a bona fide loan. . . ." (p. 23a).

However, subordination, even though it be subordination to an interest which was concurrently held to be equity, is not the only factor on which the Court of Appeals itself relied in finding that the 5½% notes did not constitute debt. Those factors, in addition to subordination to all debt, including the 5½% notes, should have influenced that Court to treat the 6½% debentures as equity. Other factors and the reasons therefor include:

(1) the finding of "thin capitalization" based on comparing assets of $1,064,000 with alleged debts of $1,078,000 (p. 21a). However, this plainly relates to the

status of the 6½% debentures rather than the 5½% notes, and contains an erroneous implication as to the proper debt-equity ratio for both the subordinated and unsubordinated 5½% notes; (2) the statement that only $5,000 was set up as equity to finance launching of the corporate venture (p. 20a). If the consensual subordination of the 6½% debentures is given effect, this is applicable only to the debentures, not to any of the 5½% notes; (3) the statement on page 20a that the substantial portion of the $609,878.33 was directed to the purchase of capital assets and to finance initial operations is certainly equally applicable in the case of the $150,000 of cash supplied to New Plantation as consideration for the 6½% debentures. Indeed, it is clear that at least $96,000 of the funds supplied thereby constituted part of the down payment to the stockholders of Old Plantation, because the New Plantation cash account was only $54,038.26 after that payment had been made, footnote 6, pp. 11a-12a; and (4) the statement of the finding that "the corporate assets of New Plantation were wholly inadequate to sustain a debt of $609,878.33." (p. 19a) Based upon the argument respecting the effect of past earnings on the going concern value of the business acquired by New Plantation, we urge that this finding is not sustainable (p. 13 ff.). But the point here is that if the assets of New Plantation "vis a vis its debts" were insufficient to sustain a debt of $609,878.33, they were certainly also insufficient to sustain a debt of $759,878.33. The latter figure includes the principal amount of the 6½% debentures. The inconsistency in dealing with the debt to be offset by assets is especially striking in view of the government's argument as to the debt-equity ratio, $759,878.33 to $5,000, instead of $609,878.33 to $155,000, which appears just before the statement of the finding

(p. 19a). That part of the opinion is copied herein on page 12.

In *Helvering* v. *Taylor*, 293 U.S. 507, at 514-5, this Court established the principle that the fact that the determination of the Commissioner is arbitrarily made, and is without rational foundation is sufficient to require the reviewing body, there the Board of Tax Appeals, to set it aside. The approach of *Taylor* should be equally applicable to the review of judgments and opinions of courts, for there cannot be any proper presumption in favor of the judgment of a court which is internally inconsistent and illogical.

The principles of *Taylor* still have vitality, and principles corresponding thereto were applied in *Bar L Ranch* v. *Phinney*, 426 F. 2d 995 (5th Cir., 1970). An even more direct authority holding that a decree must be reversed when one part is repugnant to another is *The Lottawanna*, also styled *Wilson* v. *Bell*, 20 Wallace (87 U.S.) 201, 217 (1874).

The Critical Questions in These Cases Constitute, Or Include, Questions of Law That Have Been Decided Erroneously.

The Court of Appeals erroneously proceeded upon the assumption that its review of the decision of the Tax Court was governed by Rule 52(a) of the Federal Rules of Civil Procedure and required a determination that the Tax Court's findings on the ultimate question were "clearly erroneous" before that decision could be reversed.

Generally, that rule is concerned with what are sometimes called "primary, evidentiary or circumstantial facts" not with "ultimate facts." Findings of ultimate fact tender questions of law (or mixed questions of law and fact), and the appellate court may

arrive at its own conclusions. In doing so, it may apply the primary facts found below. *Helvering* v. *Tex-Penn Oil Co.*, 300 U.S. at 491; *Kraft Foods Company*, 232 F.2d at 122, citing *Tex-Penn Oil Co.*

The error is most prejudicial in the acceptance of the finding of "thin capitalization." (p. 21a) This is surely an ultimate fact. Basic to any such finding is what constitutes "equity" or "capital" in determining the debt-equity ratio. In these cases, the most important factor is the effect of subordinations.

Furthermore, it is based on an erroneous statement of the factors that are relevant in the case of the 5½% notes in treating $1,078,000 as debt. The lower court can be reversed if it has proceeded upon an erroneous view of the law, irrespective of its findings of fact. *United States* v. *Parke Davis & Company*, 362 U.S. at 44. Nor may a court arbitrarily disregard evidence, such as the subordination of the 6½% debentures. *New York C. & H.R. Co.* v. *Beaham*. (p. 21a)

In the present case, there is no dispute about the material facts relating to allegedly "thin capitalization." Most are stipulated, and those we consider controlling, in several areas, especially subordination, were included in findings by the Court of Appeals (e.g., pp. 6a, as to the 6½% debentures and 9a as to the 5½% notes). See also Appendices III-V. p. 27a ff.

Plainly, since the $1,078,000 total includes the 6½% debentures, the Court of Appeals, in effect, declines to consider the effects of the subordination of the 6½% debentures and, in the case of the $100,000 unsubordinated 5½% notes, the effects of the subordination of $509,878.33 thereof. We urge that each constitutes a plain error of law on the part of the Court of Appeals.

Indeed, as we have noted on p. 12, the Court of Appeals appears to have recognized that all of the 5½% notes would be held to constitute debt if the $150,000 of 6½% debentures were treated as the equivalent of equity. (p. 18a.)

The error of law involved is in the failure to give effect to consensual subordination in essential conflict with the decision of this Court in *United States* v. *Key*, and with the decisions of six Courts of Appeal cited on pages 20 and 21. We have not found any contrary authority in any federal appellate court. We do not deal here with the actual figures as to the debt-equity ratio, since they have already been sufficiently considered. (pp. 11-2)

The only intimation of any reason which may be assigned by the Court of Appeals for its failure to distinguish between the unsubordinated, and the subordinated, 5½% notes which we find is in the statement that many of the arguments made about the unsubordinated notes (erroneously called "debentures") are equally applicable for the remaining $509,878.33 of partially subordinated 5½% notes (p. 16a). New Plantation issued 55 such notes, one for each stockholder of Old Plantation for each of the eleven maturities of those notes (p. 8a). There is no limitation upon the right of those stockholders to take appropriate steps for enforcement, irrespective of action taken by the other holders, although any holder might waive a default (p. 29a).

We urge that the failure to treat the subordinated 5½% notes as a separate class, having priority over the 6½% debentures, is another error requiring reversal. The opinion of the Court of Appeals adequately establishes that we presented both of these

issues to it in such manner as to require separate decisions thereon, e.g., pp. 15a-17a.

There is confusion among the circuits and the Tax Court as to the applicable debt-equity ratios which, in the final analysis, can be only resolved by this Court. It is especially important that this be done in view of the issue respecting the guarantee question, since the legal rights and obligations of guarantors differ from those of a stockholder creditor of a corporate debtor.

Before considering the question of the right to recast the transaction, we take cognizance of the reason assigned by the Court of Appeals for refusing to disregard the effects of subordination of the 6½% debentures. We have already shown that subordination was not the "single factor" which might have influenced the courts below to arrive at a different conclusion about the 6½% debentures. The most significant of the reasons assigned for that treatment of the 5½% notes are also applicable to the debentures, and the capitalization is certainly thinner.

The opinion of the Court of Appeals then proceeds to say that this loan was made with the primary motive of inducing New Plantation to employ young Bradford (p. 23a). Certainly motive is irrelevant to any decision as to the effects of subordination, and supplies no justification for refusing to recognize those effects.

No doubt, somewhat similar considerations, namely kinship with the stockholders, influenced a relative to accept something less than true debt in *Foresun, Inc.* v. *Commissioner,* 348 F.2d 1006 (6th Cir., 1965). Yet, the obligations there considered were held to be equity rather than debt. Indeed, motives like these are calculated to influence a knowledgeable investor to accept

stock, or other types of equity, rather than to insist upon undoubted debt to represent his interest in a corporation.

An additional 1% interest on the principal amount of the debentures might also be considered a motive, one that is well recognized in the market place. Correspondingly, it may be assumed that New Plantation could have procured financing, in substantial sums, from its factor, if it had been willing to pay the interest rate required instead of supplying the guarantees of Jemison Investment Company and Mr. Jemison.

Since the Transaction Was Not a Sham, To Recast It as Was Done Below Is Contrary to Decisions of This Court Which Hold That Taxing Statutes Are To Be Construed Favorably to Taxpayers and That Taxpayers Are Not Required to Select a Procedure That Produces the Largest Amount of Taxes.

The effect, and the obvious purpose of the Commissioner in seeking to have all of the 5½% notes designated as equity, was to create a justification for double taxation resulting from the denial of an interest deduction to the corporation and the imposition of a tax on constructive dividends upon payment of the principal of the notes. While it is appropriate for courts to disregard devices which are designed to circumvent the plain purposes of the statutory system, the law is still said to be that tax statutes should be construed favorably to the taxpayer, e.g., *Burnet* v. *Niagara Falls Brewing Co.*, 282 U.S. 648 (1931); *Helvering* v. *Bliss*, 293 U.S. 144 (1934); *Lewyt Corporation* v. *Commissioner*, 349 U.S. 237 (1955); and *Commissioner* v. *Sullivan*, 356 U.S. 27 (1958).

The right of corporate taxpayers to an interest deduction is plainly granted. So, that basic principle of con-

struction declared in those decisions of this Court should be applied. Under *Burnet* v. *Niagara Falls Brewing Co.*, the principle requires some leniency in viewing the facts.

The petitioners urge that this is not a case in which the form of the transaction with respect to the availability of a deduction for interest and the effect of payment of principal of the 5½% notes should be disregarded on the theory that the substance was different from its form. A taxpayer is not required to adopt the form of transaction which will increase his tax liability, and when he adopts a form which is permitted by the statute, this should not be disregarded if it represents the true intent of the parties, and is not a sham. *U.S.* v. *Cumberland Public Service Co.*, 338 U.S. 451 (1950); *Commissioner* v. *Clay B. Brown, supra.*

The organization and functioning of New Plantation were not treated as a sham by the Tax Court or the Court of Appeals. Indeed, its existence is essential to procure the double taxation result in the case of the Jemisons for the year 1963.

If we are not dealing with a sham, we see no justification for restating the transaction. Organization of New Plantation was effective to insulate Mr. and Mrs. Jemison from liability to the holders of the 6½% debentures, and it gave to the holders of the 5½% notes a direct claim against that corporation.

Since some of the 5½% notes were not subordinated, the guarantors would, upon payment thereof, rank equally with the general creditors by subrogation under Section 87 of Title 9 of the Code of Alabama of 1940 (p. 19). The right to participate with general creditors is an important, though not necessarily in-

dispensable, element in determining whether the commitment of a corporation constitutes debt rather than equity, e.g., *Kraft Foods, Baker Commodities, Inc.,* and *George A. Nye.*

If, notwithstanding the taxpayers' rights to adopt a form of transaction which is permitted by the income tax law which has lower income tax implications than a form which increases the exposure to tax liability, there would be no justification for ignoring the fact that Jemison Investment Company, as well as Mr. Jemison, was a guarantor. Economic realities would make it more appropriate to have this corporation rather than Mr. Jemison treated as the primary obligor. But if the guarantors, rather than the corporation which is made the principal debtor by the documents, are to be treated as the primary obligors, then at least all of the guarantors should be so treated. This would supply substantial relief to the Jemisons.

The transaction is recast in two respects, the first to make Mr. Jemison the primary obligor. In the other, it is said that his guarantee was an indirect contribution of capital (pp. 23a, 12a). But that is most surely no more than a fiction or figure of speech, and is logically inconsistent with treatment of a guarantor as primary obligor. The guarantor does not contribute any property to the principal debtor.

In any event, even if Mr. Jemison is to be treated as the primary obligor, with or without relief from Jemison Investment Company, no liability can be asserted unless the debt-equity ratio is too high. Here we urge that the Court of Appeals, according to its own view of this question, erred in finding that all of the 5½% notes constituted equity. This view is copied on page 12 from page 18a.

CONCLUSION

The decision of the Court of Appeals deals erroneously with several matters of importance in the federal income tax field which may be expected to recur constantly. The position of guarantors of corporate debt needs to be made clear and the effects of subordination in the determination of what is so-called equity should be stated to conform with the decisions of the federal courts in bankruptcy proceedings. We respectfully request that the writ of certiorari be issued.

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